

Client Alert

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Rule 10b5-1 Plans: Recommended Guidelines for Managing Risks in the Current Environment

Linda Chatman Thomsen, Director of the SEC's Enforcement Division, announced in October 2007 that her division would probe issues associated with the use of 10b5-1 trading plans by corporate insiders,¹ and the SEC staff recently has said that 10b5-1 plan issues continue to be an area of focus.² Thomsen identified disclosure issues, unusually favorable dates to begin or halt the sale of company stock, and the use excessive discretion as potentially abusive practices.

The media also has taken notice. Media reports of insiders' aggressive, if not illegal, uses of 10b5-1 trading plans have become almost commonplace.³

This *Client Alert* discusses how 10b5-1 plans work, potentially abusive practices that academics, the media and the SEC have identified, and suggestions for 10b5-1 plan guidelines that companies should consider adopting to reduce the risk of being criticized for permitting their insiders to engage in abusive practices.

About the Rule

Rule 10b5-1, adopted by the Securities and Exchange Commission in August 2000, clarifies that insider trading liability merely requires proof of trading while "aware" of material non-

public information and not that the trader actually "used" the information when making the trade.⁴ Although it potentially increases exposure to insider trading liability, Rule 10b5-1 also contains two important affirmative defenses.

The first affirmative defense is available to individuals and entities making a purchase or sale who demonstrate that the purchase or sale was pursuant to a binding contract, specific instruction or written plan entered into before becoming aware of the material non-public information. This affirmative defense was intended to provide appropriate flexibility to those who wish to plan securities transactions in advance at a time when they are not aware of material non-public information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material non-public information.⁵

The second affirmative defense is available only to entities. It is available where the individual making the investment decision on behalf of the entity was not aware of the information, and the entity had implemented reasonable policies and procedures to prevent insider trading.⁶ This *Client Alert* focuses on the first affirmative defense.

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Requirements of the Rule

In order to comply with the first affirmative defense, the individual or entity must demonstrate the following:

- Before becoming aware of the information, the individual had entered into a binding contract to purchase or sell the security, provided instructions to another person to execute the trade for the instructing person's account, or adopted a written plan for trading securities;
- The contract, instructions or plan either:
 - expressly specified the amount, price and date;
 - provided a written formula or algorithm, or computer program, for determining amounts, prices and dates; or
 - did not permit the person to exercise any subsequent influence over how, when or whether to effect purchases or sales; provided, that no other person who did exercise such influence was aware of material non-public information when doing so; and
- The purchase or sale that occurred was pursuant to the prior contract, instruction or plan.⁷

This last requirement will not be deemed satisfied if, among other things, the individual who entered into the contract, instruction or plan altered or deviated from it, or entered into or altered a corresponding or hedging transaction or position with respect to those securities. The affirmative defense is available only when the contract, instruction or plan was given or entered into in good faith, and not as a plan or scheme to evade the prohibitions of Rule 10b5-1.⁸

The Rule makes clear that the contract, instruction or plan can either expressly specify the amount, price or date of purchases or sales, or provide a formula, algorithm or computer program for determining them. For example, an employee could enter into a plan that

provides that the employee will exercise stock options and sell the underlying shares one month before each date on which his or her child's college tuition is due, where the amount of the trade is linked to the cost of the tuition. An insider also could design a written trading plan that tracks or corresponds to a market index, market segment or group of securities.⁹

The Rule also allows an individual to adopt a plan that delegates complete or partial discretion to determine amounts, prices and dates to another individual who is not aware of material non-public information, provided that the plan does not permit the individual entering into the plan to exercise any subsequent influence over the purchases or sales.¹⁰

Plan Deviations and Modifications

Rule 10b5-1 states that the affirmative defense does not apply if the individual who entered into the contract, instruction or plan altered or deviated from it.¹¹ Thus, for example, if an insider enters into a contract or plan to sell 1,000 shares of his or her company's stock when unaware of material non-public information, and then later doubles his or her planned sale to 2,000 shares when he or she is aware of material non-public information, he or she will lose the defense for the entire 2,000 shares.

The SEC has differentiated between plan deviations and plan modifications. According to the SEC, an individual acting in good faith may modify a prior contract, instruction or plan so long as he or she is not aware of material non-public information at the time of the modification.¹² In that case, a purchase or sale that complies with the modified contract, instruction or plan will be considered to be pursuant to a new contract, instruction or plan.

The good faith requirement is an important constraining, and problematic,

factor because it is inherently subjective. Modifications that do not have a good faith justification will lose the benefit of the affirmative defense. Frequent modifications may be especially hard to justify. Moreover, it is possible that a modification that is not entered into in good faith may also raise into question the good faith at the time the plan was entered into. In such a case, the individual entering into the plan risks losing the affirmative defense for all transactions pursuant to the plan, even those that occurred prior to the plan modification, as well as undermining the *bona fides* of subsequent plans.

Hedging Transactions

Hedging transactions are treated similarly to plan deviations. Rule 10b5-1 states that the affirmative defense does not apply to purchases and sales of securities where the person entering into the contract, instruction or plan enters into or alters a corresponding or hedging transaction or position with respect to the securities. The affirmative defense would be inapplicable to both the transaction pursuant to the contract, instruction or plan and to the hedging transaction.¹³

Early Termination of Plan

Neither the Rule nor the proposing or adopting releases address the consequence of early termination of plans.¹⁴ Early termination can be viewed as a plan modification in which the amount of future transactions under the plan is reduced to zero. Since early terminations do not involve sales into the market, they trigger no insider trading violation in and of themselves. However, as with plan modifications, early termination may call into question the good faith element at the time of entering into the plan, and thus puts in jeopardy the affirmative defense for all prior transactions pursuant to the plan, as well as transactions under subsequent plans.

Potential Abuses of 10b5-1 Insider Trading Plans

As was the case with the options backdating scandal, an academic study sparked media and SEC interest in possibly abusive practices involving 10b5-1 plans.¹⁵ Stanford University Graduate School of Business assistant professor Alan D. Jagolinzer examined more than 100,000 trades by more than 3,000 executives at almost 1,250 companies and the return on trades made through 10b5-1 plans.¹⁵ He found that trades under 10b5-1 plans beat the market by more than 6 percent during a period of six months, while executives at the same companies who traded without 10b5-1 plans beat the market by only 1.9 percent. Specifically, Jagolinzer found that “a substantive proportion of selected 10b5-1 plan initiations are associated with pending adverse news disclosure” and “early sales plan termination is, on average, associated with pending positive firm performance.” His analysis of the data suggests that some insiders have used 10b5-1 trading plans so “strategically” that the insider trading laws may have been—and currently are being—broken.

Jagolinzer's research prompted the SEC to undertake a more detailed study of 10b5-1 plans. In a March 8, 2007 speech at the Corporate Counsel Institute, Thomsen said that Jagolinzer's study raises the possibility “that the plans are being abused in various ways to facilitate trading based on inside information.” Thomsen warned, “We're looking at this hard. We want to make sure that people are not doing here what they were doing with stock options. If executives are in fact trading on inside information and using a plan for cover, they should expect the ‘safe harbor’ to provide no defense.”¹⁶

Judging by published reports of questionable 10b5-1 plan practices by executives at more than a few prominent public companies, Thomsen's warning may have come too late for some.¹⁷

Second Academic Study of 10b5-1 Plans

More recently, Jagolinzer and two colleagues conducted a study that led them to a counterintuitive conclusion: Voluntary disclosure regarding 10b5-1 plans is associated with greater abnormal returns from insiders' trades. In fact, they found a correlation between greater specificity in disclosure and greater declines in the insiders' companies' stock prices following the insiders' sales pursuant to 10b5-1 plans.¹⁸

The authors posit that companies and insiders recognize that public disclosure of plans can provide important litigation benefits. Although a properly adopted 10b5-1 plan will provide an affirmative defense to insider trading liability whether or not it is publicly disclosed, courts typically will not take judicial notice of the existence of the 10b5-1 plan at the motion to dismiss phase if the plan has not been publicly disclosed.¹⁹ In other words, disclosure increases the possibility of a low-cost dismissal. But there are costs associated with disclosing a plan, particularly if disclosure of the existence of a plan provides a signal to the market before the insider can complete a trade. The authors find that this cost-benefit analysis is resolved in favor of disclosure most often in cases where disclosure provides the greatest perceived litigation benefit, such as when the company has a high litigation risk generally and when the ability to trade provides the insider with the greatest opportunity to profit.²⁰

Possible SEC Action

This new study may spur the SEC to propose a rule that is tailored to prevent 10b5-1 plan abuses by requiring more than just disclosure of plan adoption. In 2002, the SEC considered a rule proposal that would have required companies to report when insiders adopted, terminated or modified 10b5-1 plans.²¹ Requiring such disclosure

is a concept that Thomsen discussed, noting that "asymmetrical disclosure" or "disclosure of entry into a 10b5-1 plan, without timely disclosure of related plan modifications or terminations" is a method that insiders use to abuse 10b5-1 plans. Given that required disclosure of plan terminations and modifications was part of the rule that the SEC proposed in 2002, it may resurface in future rulemaking. The SEC also might require issuers to disclose whether they have adopted internal policies or guidelines to limit abusive practices by insiders.

If a new rule requiring additional disclosure is adopted, it would not be surprising to see the Staff charge a company with disclosure violations, even in cases where the Staff was not prepared to charge the company's insiders with securities law violations.²²

Better Practices to Consider

Companies can limit opportunities for their insiders to engage in abusive practices, and more importantly, to avoid the appearance of practices that might be viewed as abusive based on later developments, by adopting and enforcing 10b5-1 guidelines that insiders must follow to establish plans. Companies should consider the adoption of guidelines that address the following items:

- *Plan approval.* Plans should use one or more company-approved templates and should be approved by the company's general counsel or compliance officer.
- *Cooling-off period.* The period of time between the establishment of a plan and commencement of sales should be at least 30 days; some companies even impose 60 day cooling-off periods.
- *Trading windows.* Insiders should not be allowed to enter into 10b5-1 plans outside of ordinary open trading windows. Some commentators recommend that companies permit their insiders to enter into 10b5-1

plans only within a single, short window each year, such as after the filing of the company's Annual Report on Form 10-K. This, the commentators suggest, would support the insider's good faith and lack of material non-public information at the time he or she enters into the plan.

- *One insider; one plan.* Companies should prohibit insiders from entering into multiple, overlapping 10b5-1 plans. Some insiders have entered into multiple plans with the intention of terminating one or more of the plans depending on how circumstances develop. Such a practice may fail the good faith requirements for plan adoption.
- *Disclosure.* Guidelines should call for prompt disclosure of the adoption of 10b5-1 plans by insiders through a press release or Current Report on Form 8-K. As noted previously, some courts have taken judicial notice of publicly disclosed 10b5-1 plans to dismiss insider trading complaints at the motion to dismiss phase.²³ If the plan is not publicly disclosed, the insider would be unable to present evidence of the existence of the 10b5-1 plan until a later phase of the litigation. Although practices vary with respect to the amount of detail provided, the disclosure should at least identify the insider, indicate the maximum number of shares or dollar amount of sales covered by the plan, and state the period during which sales may be made. Thomsen also made the point on October 10, 2007 that companies should provide "symmetrical disclosure."²⁴ In other words, if a company announces that insiders have entered into plans, it probably also should announce modifications or terminations of the plans.
- *Modifications.* Guidelines should provide that modifications cannot be made other than during open trading windows, with a minimum 30-day waiting period before changes take effect.
- *Terminations.* Some companies prohibit terminations of plans other than during open trading windows. However, we believe it is more common for companies to permit insiders to terminate their 10b5-1 plans at any time but then impose a 180-day waiting period before a new 10b5-1 plan can be adopted and a 30-day waiting period before any additional trades outside of a plan.
- *No "fast selling" and no sales outside of the plan.* Guidelines should encourage insiders to design plans to cause a number of smaller sales over time to minimize the appearance of sales timed with material non-public information. Insiders also should avoid sales outside of the plan (especially in large concentrations of sales during a short period of time) to strengthen the affirmative defense provided by Rule 10b5-1. Some guidelines call for a minimum and/or maximum plan duration to address this issue, with the minimum duration typically being six to 12 months and the maximum being two years.
- *Execution broker.* The company should consider specifying the execution broker who insiders must use or require insiders to obtain company approval of the broker they intend to use. Use of a company-specified broker provides numerous advantages, particularly if the designated broker is also the designated broker for option exercises. For example, use of a designated broker can expedite Form 4 filings, provide a consistent and monitored 10b5-1 plan process, and facilitate efficient stock option exercise management. Having the 10b5-1 plan broker be someone other than the broker at the insider's wealth management firm will help avoid appearances of conflicts of interest.
- *Documentation.* The SEC may soon require insiders to keep documentation that 10b5-1 plans are entered into at a time when insiders are not aware of material non-public

information. Companies should consider monitoring the adoption of 10b5-1 plans and mandating that the company and the insiders keep plan adoption documentation that is sufficiently detailed to show compliance with the Rule.

Conclusion

In sum, 10b5-1 trading plans remain a viable and permissible mechanism for insiders to sell stock and diversify their portfolios. However, to qualify for the protection afforded by 10b5-1 plans against allegations of insider trading, the plans must be prepared and executed within the confines of Rule 10b5-1. The potential for abuse of these plans is substantial and the possibility for the appearance of abuses in today's environment is even greater, so companies should consider adopting guidelines for the adoption of plans by insiders to minimize the risk of SEC investigations and very unflattering and widely disseminated news reports. Companies and insiders also need to be prepared to respond to expected SEC staff enforcement and other activities in the field which are likely to focus even more scrutiny on 10b5-1 trading plans.

Endnotes

¹ Linda Chatman Thomsen, Director, US Sec. & Exch. Comm'n, Speech by SEC Staff: Opening Remarks Before the 15th Annual NASPP Conference (Oct. 10, 2007), available at <http://www.sec.gov/news/speech/2007/spch101007lct.htm>.

² In June 2008 at the National Investor Relations Institute Annual Conference, Andrew Petillon, the Associate Regional Director of the SEC's Los Angeles Regional Office, confirmed that the Staff continues to focus on Rule 10b5-1 issues. Posting of Dave Lynn to TheCorporateCounsel.net blog, "More Rule 10b5-1 Plan Research," <http://www.thecorporatecounsel.net/blog/archive/001830.html> (June 17, 2008, 06:19 EST).

³ See, e.g., Gretchen Morgenson, "Judge Says Countrywide Officers Must Face Suit by Shareholders," *The New York Times*, May 15, 2008, at C.1; Ed Welsch, "Trading Plans

Offer A Good Clue to Sell—Aggressive 10b5-1s Especially Predict Underperformance," *Wall Street Journal*, April 9, 2008, at C4; Jack Davis and Chris O'Brien, "Applied Executives Hit Option Window," *San Jose Mercury News*, March 30, 2008; Damian Paletta, Valerie Bauerlein and James R. Hagerty, "Countrywide Seeks Rescue Deal—Bank of America Eyes Stricken Home Lender As Crisis Grinds On," *Wall Street Journal*, January 11, 2008, at A1; Gretchen Morgenson, "Stock Sales by Chief of Lender Questioned," *The New York Times*, October 11, 2007, at C1; Matt Krantz, "Execs Often Show Good Timing with Stock-Sales Plans," *USA Today*, May 27, 2008, available at http://www.usatoday.com/money/companies/management/2008-05-27-executive-stock-sales_N.htm; Jane Sasseen et al., "Insiders with a Curious Edge: How Corporate Executives Seem to Be Violating the Spirit, If Not the Letter, of a Rule Intended to Prevent Insider Trading," *BusinessWeek*, December 18, 2006, available at http://businessweek.com/magazine/content/06_51/b4014045.htm; Jane Sasseen, "A Closer Look at Trades by Top Brass: Some Execs May Be Abusing an SEC 'Safe Harbor' Rule on Insider Stock Sales," *BusinessWeek*, November 13, 2006, available at http://www.businessweek.com/magazine/content/06_46/b4009063.htm.

⁴ Release Nos. 33-7881; 34-43154; IC-24599; File No. S7-31-99 (Aug. 15, 2000) (the "Adopting Release"), available at <http://www.sec.gov/rules/final/33-7881.htm>. A copy of the Adopting Release can be obtained by accessing the SEC's Web site at www.sec.gov.

⁵ Adopting Release, p. 22.

⁶ Adopting Release, p. 24.

⁷ Exchange Act Rule 10b5-1(c)(1)(i).

⁸ Exchange Act Rule 10b5-1(c)(1)(ii).

⁹ Adopting Release, pp. 23-24.

¹⁰ Adopting Release, pp. 22-23.

¹¹ Exchange Act Rule 10b5-1(c)(1)(i).

¹² Adopting Release, p. 59 n. 111.

¹³ Exchange Act Rule 10b5-1(c)(1)(i)(C).

¹⁴ In a set of interpretations of Rule 10b5-1, the SEC Staff addressed this issue of early termination, stating: "Termination of a plan, or the cancellation of one or more plan transactions, could affect the availability of the Rule 10b5-1(c) defense for prior plan transactions if it calls into question whether the plan was 'entered into in good faith and not as part of a plan or scheme to evade' the insider trading rules within the meaning of

- Rule 10b5-1(c)(1)(ii). The absence of good faith or presence of a scheme to evade would eliminate the Rule 10b5-1(c) defense for prior transactions under the plan." *Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations*, Fourth Supplement (May 20, 2001).
- ¹⁵ Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade* (Sept. 17, 2007), available at <http://www.gsb.stanford.edu/cldr/cgrp/documents/10b5-1Jagolinzer.pdf>.
- ¹⁶ Linda Chatman Thomsen, Director, US Sec. & Exch. Comm'n, Speech by SEC Staff: Remarks at the 2007 Corporate Counsel Institute (March 8, 2007), available at <http://www.sec.gov/news/speech/2007/spch030807lct2.htm>.
- ¹⁷ See, e.g., Jane Sasseen, "A Closer Look at Trades by Top Brass: Some Execs May Be Abusing an SEC 'Safe Harbor' Rule on Insider Stock Sales," *BusinessWeek*, November 13, 2006, available at http://www.businessweek.com/magazine/content/06_46/b4009063.htm.
- ¹⁸ The study analyzed more than 1,500 10b5-1 plan disclosures during the period between October 2000 and December 2006, and grouped companies according to whether the companies had low, moderate or detailed Rule 10b5-1 plan disclosures. The authors then looked at subsequent firm returns and earnings performance from each group of companies. The authors found that "more specific 10b5-1 plan disclosures are associated with more negative post-trade abnormal returns" and that "the association between sales transactions and subsequent negative performance is increasing in disclosure specificity, after controlling for other factors that are associated with firm returns." M. Todd Henderson, Alan D. Jagolinzer & Karl A. Muller, III, *Scienter Discloser*, U. CHI. LAW & ECON., Olin Working Paper No. 411 (May 27, 2008), available at SSRN: <http://ssrn.com/abstract=1137928>.
- ¹⁹ Henderson, Jagolinzer and Muller, pp. 7-8 (citing *Friedman v. Rayovac Corp.*, 291 F. Supp. 2d 845 (W.D. Wis. 2003) and *SEC v. Healthsouth Corp.*, 261 F. Supp. 2d 1298, 1322-23 (N.D. Ala. 2003)).
- ²⁰ Henderson, Jagolinzer and Muller, p. 24.
- ²¹ Release Nos. 33-8090; 34-45742; File No. S7-09-02 (April 12, 2002) (the "Proposing Release"). A copy of the Proposing Release can be obtained by accessing the SEC's Web site at www.sec.gov.
- ²² See, e.g., *SEC Charges Scottrade for Misrepresentations to Customers*, Press Release No. 2008-120 (June 24, 2008), available at <http://www.sec.gov/news/press/2008/2008-120.htm>; *SEC Charges Banc of America Investment Services With Failing to Disclose It Favored Affiliated Mutual Funds*, Press Release No. 2008-72 (May 1, 2008), available at <http://www.sec.gov/news/press/2008/2008-72.htm>; *Chevron to Pay \$30 Million to Settle Charges For Improper Payments to Iraq Under U.N. Oil For Food Program*, Press Release No. 2007-230 (Nov. 14, 2007), available at <http://www.sec.gov/news/press/2007/2007-230.htm>; *SEC Charges Conagra Foods, Inc. in Financial Fraud and Accounting Case: ConAgra Agrees to Pay \$45 Million Penalty to Settle Charges*, Press Release No. 2007-142 (July 25, 2007), available at <http://www.sec.gov/news/press/2007/2007-142.htm>; *SEC Charges the Walt Disney Company for Failing to Disclose Relationships Between Disney and Its Directors*, Press Release No. 2004-176 (Dec. 20, 2004), available at <http://www.sec.gov/news/press/2004-176.htm> (charging Disney for failure to disclose related-party transactions between Disney and its directors and certain compensation paid to a Disney director).
- ²³ See note 19 above. See also "More on Trading Plans/Restrictions and Motions to Dismiss: Monterey Pasta Co. and Rayovac Corp.," RiskMetrics Group (November 24, 2003), available at http://slw.riskmetrics.com/2003/11/more_on_trading_plansrestricti.html.
- ²⁴ Linda Chatman Thomsen, Director, US Sec. & Exch. Comm'n, Speech by SEC Staff: Opening Remarks Before the 15th Annual NASPP Conference (Oct. 10, 2007), available at <http://www.sec.gov/news/speech/2007/spch101007lct.htm>.

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